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SUBJECT: Egypt: Inflation Update

REF: Cairo 3021

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Summary

11. (U) Inflation dropped to 7.5% year-on-year (y/y) in October, down from 9.3% y/y in September. The CBE maintained interest rates unchanged at a November 1 meeting, but indicated that inflation could reach the upper limit of CBE's "comfort zone." This is the first public sign of a move toward an inflation targeting monetary policy. Recent appreciation of the Egyptian pound (the pound or LE) against the U.S. dollar is further evidence that CBE is moving away from a pegged exchange rate, a necessary step for inflation targeting to work. While rising international commodity prices are driving inflation, greater domestic demand and rising wages have also contributed. Economic growth has not "trickled down" to the lower classes, however, and most Egyptian have only experienced the downside of growth: rising prices.

Inflation Declines in October

12. (U) Egypt's headline inflation rate dropped to 7.5% y/y in October, from 9.3% y/y in September, according to figures released by the Central Agency for Public Mobilization and Statistics (CAPMAS). CAPMAS has not yet released figures for specific categories of the Consumer Price Index (CPI) in October, but analysts expect food prices will show the greatest increase, as they did in September. Food prices rose 16.4% in September, due in large part to the effect of Ramadan (reftel), which began in mid-September and continued through mid-October. A recent report by the Ministry of Social Solidarity indicated that prices of flour increased by 50% y/y in October, edible oil by 20% y/y, dairy products by 15% y/y, and meat/poultry by 11% y/y.

CBE Maintains Interest Rates

13. (U) At its November 1 meeting, CBE's Monetary Policy Committee (MPC) kept overnight interest rates unchanged at 8.75% (deposit) and 10.75% (lending). A press statement after the meeting indicated the decision was based on a September inflation figure of 8.8% y/y, using the old CPI. The statement recognized that the rate for September increased to 9.3% when using the new CPI introduced that same month. According to CBE, current inflation is driven mainly by rising domestic food prices on the back of higher international

commodity prices. Rising food prices are driving inflation in other sectors, as is increased demand from higher economic growth. Over the medium-term, inflationary pressure could rise above the upper level of CBE's "comfort zone," according to the statement. CBE said it would continue to monitor economic developments, especially factors underlying inflation, and would not hesitate to adjust interest rates to ensure medium-term price stability.

Inflation Targeting v. Pegged Exchange Rate

14. (U) This is the first public mention of a "comfort zone" for inflation, an indication that CBE is moving toward an inflation targeting monetary policy with benchmark interest rates as the anchor. Recent movement in the LE/\$ exchange rate is further evidence that CBE is moving away from a de facto pegged exchange, a necessary step for inflation targeting to work properly. The pound has appreciated 3.8% since July (from 5.75 \$/LE to 5.46 \$/LE currently). In a recent report on Egypt, Deutsche Bank projected the exchange rate would reach 5.35 \$/LE by year end, calling the appreciation evidence of a "regime shift at CBE."

15. (U) Most of Egypt's imported food commodities, such as wheat, corn and edible oil, are priced in U.S. dollars, so Egypt imports the inflation that comes with the rising cost of those goods. While the pound's appreciation against the dollar may dampen inflation, food prices are likely to continue rising, as approximately 40% of Egypt's food imports, mostly processed foods, come from the EU. The pound has recently lost value against the euro, moving from LE 7.6/1 in July to LE8/1 currently.

Domestic Demand

16. (U) Although rising import prices are the main inflationary pressure in Egypt, domestic growth and higher wages have also contributed. Demand pressures are particularly evident in the booming construction sector. Steel and cement prices have risen sharply, with the latter being less susceptible to international pressures and more dependent on domestic demand factors. Average ex-factory cement prices have risen from LE177 (\$32) in 2003 to over LE350 (\$64) per ton in 2007. Bank credit to the private sector has also increased significantly, reaching 12.3% in June 2007, up from 8.6% in June 2006. Credit growth from the highly liquid banking sector is likely to continue over the next year, supporting the current investment boom and greater private consumption.

Wage Growth

17. (U) While most analysts note that wages, particularly for the lower classes, are not keeping pace with inflation, there are signs of rising wages in some sectors. Official wage data are unreliable, but anecdotal evidence suggests that wages for unskilled labor are rising in the construction sector. Construction wages grew 25% over the past three years, a level high enough to entice Egyptian workers back from the Gulf, according to Minister of Housing Ahmed El-Maghrabi. Speaking to the press, Maghrabi stated that wages for unskilled daily labor - used in both construction and agriculture - have risen 15% over the past year alone. His statements were echoed by Hanaiya El-Itriby, Head of the Agricultural Research Center, who told us that agricultural labor prices are rising, as more day laborers are choosing to work on construction sites rather than in the fields. Wages in the textile industry have also increased over the last few years. According to figures released by the Ministry of Finance, wages in the garment industry rose from LE350 (\$64)/month in 2004 to LE800 (\$146)/month currently.

18. (U) Wages for skilled workers are also on the rise. The GOE implemented a 50% increase in teachers' base salaries in June 2007 and recently announced that journalists' wages will soon go up by LE 200/month. A study released in early 2007 by the Hay Group, an international human resources consulting firm, predicted an 18% increase in fixed salaries (salaries + benefits) for professionals and senior managers, based on the salary trends of 85 companies in

various sectors in Egypt over the last few years. Construction and petroleum/gas companies have been offering internationally competitive salaries to attract high-caliber employees in the last few years, forcing companies across the board to raise salaries to compete for skilled labor.

Comment

19. (SBU) While high levels of economic growth and rising wages are positive trends, many of the poor have yet to see the benefits of economic expansion. The poor have, however experienced the downside of economic growth in the form of higher prices. Inflation, particularly increased food prices, disproportionately affects the poor, who spend a higher percentage of their income on basic food items. Saeed El Alfy, Head of Egypt's Consumer Protection Agency and a member of the NDP General Secretariat, told us that his agency receives thousands of calls a week, 90% of which are complaints about high prices. Although his agency can do nothing to regulate prices, the Egyptian public still believes it is the government's responsibility to keep prices artificially low. It is this perception that makes rationalizing subsidies, particularly food subsidies, such a difficult task for the government, according to El Alfy. The government and the NDP have recently ratcheted up attention to the problem, making social issues the key subject of the recent NDP conference. Despite attention to the issue, the government has yet to articulate a vision for improving social benefits, adding to the frustration of the lower classes.
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